Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Briggs | Analyst: Jeff Garnier | Bill Number: AB 867

Related Bills: SB 5 & SB 1233 (1997) | Telephone: 845-5322 | Introduced Date: 02/25/1999

Attorney: Doug Bramhall | Sponsor:

SUBJECT: S Corporation Taxation/Deletes 1 1/2% Tax Rate For Income Years 1/1/19990 Or After

SUMMARY

This bill would eliminate all taxes under the Bank and Corporation Tax Law (B&CTL) on S corporations.

EFFECTIVE DATE

As a tax levy, this bill would be effective and operative for income years beginning on or after January 1, 1999.

SPECIFIC FINDINGS

For income years beginning on or after January 1, 1987, California conformed to the federal S corporation provisions, with specified exceptions. For federal purposes, the taxable income or loss and credits of an S corporation are taken into account by the corporation's shareholders, rather than by the entity, regardless of whether such income is distributed. The shareholders of a small business corporation may elect to have the corporation treated as an S corporation.

Under California law, in addition to the pass-through of the S corporation's income, deductions and credits to its shareholders, an S corporation continues to be subject to the franchise tax, in an amount equal to the greater of the minimum tax ($800) or 1.5% (2.5% prior to 1994) of its net income for the income year. Credits are allowed against this corporate level tax in an amount equal to one-third of the amount otherwise allowable. An S corporation is not subject to the alternative minimum tax. S corporation are allowed "net operating losses," which can be carried forward as deductions against the income subject to the 1.5% S corporation tax.

Under federal and state law S corporations are subject to taxes on "built-in gains" (BIG), excess net passive income, and "last-in, first-out" (LIFO) recapture taxes. These corporate level taxes only apply to S corporations that were formerly C corporations. Distributable taxable income to shareholders is reduced by any BIG or excess net passive income tax paid by the S corporation for the year. Distributable taxable income is not reduced by any LIFO recapture tax paid by the S corporation. Under California law, these three taxes are assessed at the rate applicable to C corportions (8.84%).

The BIG tax is designed to tax gains on the disposition of assets by an S corporation where tax benefits (e.g. depreciation) or appreciation occurred during the corporation's "C" years, therefore, properly taxing the gain at the C

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corporation tax rate. BIG tax is assessed on recognized gain from the disposition by an S corporation of an asset that can be attributed to the corporation's "C" period. The BIG tax applies for ten years after the corporation makes its S corporation election. Other detailed rules apply to the application of the BIG tax.

An S corporation has excess net passive income if it has: 1) C corporation earnings and profits (accumulated profits taxed under the C corporation tax rate and not distributed to the shareholders) and 2) passive investment income that exceeds 25% of the gross receipts for the year. Passive income is defined as income received from rents, royalties, dividends, interest annuities and the gain from the sale of stock and securities. Net passive income is defined as passive income reduced by directly related expenses incurred in earning the passive income. Finally, excess net passive income is defined as the amount of net passive income that exceeds 25% of the corporation's gross receipts.

The LIFO recapture tax applies to corporations that used the LIFO method of inventory the last day of its C corporation tax year (and, therefore, before its first S corporation year.) The tax is assessed on the difference in the basis of the inventory computed under the LIFO method and the "first-in, first-out" (FIFO) method of inventory on the last day of the corporation's last "C" year. This difference represents "book" or "paper" deductions taken during C corporations tax years. The tax is paid in four equal installments. The first installment is payable with the final return as a C corporation and the three remaining installments are payable by the S corporation with its returns for the first three income years of the S corporation.

This bill would eliminate all taxes under the B&CTL, including the minimum franchise tax (currently $800), the measured tax (currently 1.5%), and the BIG, LIFO and excess net passive income taxes. The author's staff has indicated that he desires to eliminate only the measured tax of 1.5%. Staff will work with the author's office to draft amendments which accomplish that intention.

Policy Considerations

Under California law, generally, all entities that have limited liability (e.g., limited partnerships, C corporations, etc.) are subject to an annual tax equal to the minimum franchise tax. By eliminating the minimum franchise tax on S corporations, this bill would provide favorable treatment to S corporations not generally allowed to other limited liability entities. This concern would be eliminated by if the bill is amended as noted above.

Current law allows a corporation that elects to be a federal S corporation the ability to elect separately to be a C corporation for California tax purposes. That separate state election was negotiated into law as a result of the imposition of a measured tax on California S corporations. With the elimination of a measured tax on S corporations, the basis for granting the separate election is eliminated. Conformity policy would make federal entity classification elections binding for state purposes.

Implementation Considerations

Most of the language in the current law dealing with S corporations is a direct result of the imposition of the 1.5% measured tax. The elimination of that tax makes much of the current statutory language unnecessary. Retaining it in the code may cause confusion to taxpayers and make the code itself more complex than necessary. Consideration should be given to substantially modifying existing statutes rather than merely amending it as proposed.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the departments cost.

Tax Revenue Estimate

Revenue losses from eliminating all taxes on “S” corporations are estimated as follows:

Effective January 1, 1999 Assumed Enactment After June 30, 1999 (in millions)			
1999-0	2000-1	2001-2	2002-3
($505)	($375)	($395)	($415)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The above estimates are based on current state data and reflect the 1.5% tax, the $800 minimum franchise tax, and miscellaneous taxes currently imposed on S corporations. The number of S corporations doing business in California is projected to be approximately 125,400 for the 1999 income year.

BOARD POSITION

Pending.